Preventing and Managing Project Fraud Risk

THE KNOWN UNKNOWN
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Presentation Outline
Introduction:

- Construction projects and contracts are very susceptible to the risk of fraud.
- This happens mostly because of the very nature of the business, one that is based on a multitude of stakeholders with competing interests. The constant pressure from decision makers (owners) for the achievement of the often mistakenly set goals, increases that risk.
- It is very common that a well studied budget and schedule get revised (meaning, “cut down”) to ensure certain KPIs are achieved and with that, the project approved. Such cuts often reduce the level of control anticipated.
Introduction: (cont.)

- The also constant pressure from contractors themselves to continue growing or simply continue in business may also force them to make mistakes on their estimating and bidding processes.

- In addition, construction is particularly susceptible to the negative impact of hard to predict environmental and social events.

- These elements create a perfect storm scenario that makes fraud risk such a relevant matter in that industry.

- The presentation will introduce controls that may be implemented in a project to help prevent the risk of fraud. It will also discuss best practice to resolve fraud related issues in construction projects.
The fraud triangle:

Trusted persons become trust violators when:

• they conceive of themselves as having a financial problem which is non-shareable,
• are aware this problem can be secretly resolved by violation of the position of financial trust, and
• are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conceptions of themselves as users of the entrusted funds or property.¹

¹ Donald R. Cressey, Other People’s Money (Montclair: Patterson Smith, 1973) p. 30.
When will fraud happen?

Source: ARCADIS - Change Orders, Managing the Inevitable
2020 ACFE Report to the Nations
Survey Key Facts

- Two facts:
  1. Occupational fraud imposes huge costs on businesses and government agencies around the world.
  2. To deal with this problem, we must first understand it.

- The report in numbers:
  - 2,504 fraud cases between 01/2018 and 09/2019
  - Regardless of company size
  - 125 countries
  - Losses > USD $ 3.6 billion
  - 46% corresponds to North America

- This is the most comprehensive examination available of the costs, methods, victims, and perpetrators of occupational fraud.
Three Types of Occupational Fraud:

1. **Asset misappropriation**
   - An employee stealing or misusing the employing organization’s resources, occurs in most fraud schemes (86% of cases). Median loss at USD 100,000 per case.

2. **Financial statement fraud**
   - Perpetrator intentionally causes a material misstatement or omission in the organization’s financial statements (10% of cases) but costliest category of occupational fraud, median loss at USD 954,000.

3. **Corruption**
   - Offenses such as bribery, conflicts of interest, and extortion—in the middle in terms of frequency and financial damage (43% of cases). Median loss of USD 200,000.

High Level Findings:

High Level Findings: (cont.)

Owners/executives committed only 20% of occupational frauds, but they caused the largest losses:
- **Owner/Executive**: $600,000
- **Manager**: $150,000
- **Employee**: $60,000

More than half of all occupational frauds came from these four departments:
- **Operations**: 15%
- **Accounting**: 14%
- **Executive/Upper Management**: 12%
- **Sales**: 11%

**Men committed 72% of all occupational fraud, and also caused larger losses than women.**

80% of fraudsters faced some form of internal discipline from the victim organization.

46% of victim organizations declined to refer cases to law enforcement because internal discipline was sufficient.

42% of occupational fraudsters were living beyond their means.

26% of occupational fraudsters were experiencing financial difficulties.
High Level Findings: (cont.)
More than a third of fraudsters committed more than one fraud.
Asset Misappropriation Sub-Schemes:

- **Asset misappropriation:** A scheme in which an employee steals or misuses the employing organization’s resources (e.g., theft of company cash, false billing schemes, or inflated expense reports).

- **Billing scheme:** A fraudulent disbursement scheme in which a person causes their employer to issue a payment by submitting invoices for fictitious goods or services, inflated invoices, or invoices for personal purchases (e.g., employee creates a shell company and bills employer for services not actually rendered; employee purchases personal items and submits an invoice to employer for payment).

- **Noncash misappropriations:** Any scheme in which an employee steals or misuses noncash assets of the victim organization (e.g., employee steals inventory from a warehouse or storeroom; employee steals or misuses confidential customer information).

- **Check or payment tampering scheme:** A fraudulent disbursement scheme in which a person steals their employer’s funds by intercepting, forging, or altering a check or electronic payment drawn on one of the organization’s bank accounts (e.g., employee steals blank company checks and makes them out to themself or an accomplice; employee re-routes an outgoing electronic payment to a vendor to be deposited into their own bank account).

Understanding the methods fraudsters use to conceal their crimes can assist organizations in more effectively detecting and preventing similar schemes in the future.

- Created fraudulent physical documents (40%)
- Altered physical documents (36%)
- Altered electronic documents or files (27%)
- Created fraudulent electronic documents or files (26%)

Detection is important in fraud investigation. Its speed and the way it happens can determine the size of the fraud.

It is also key to fraud prevention (perception that fraud will be detected).

Trends relating to how and when fraud is initially detected, as well as who detects it, improve the effectiveness of fraud detection and prevention.
- Internal control weaknesses that contribute to fraud: Various factors can facilitate a perpetrator’s ability to commit and conceal an occupational fraud scheme.

Progress of Anti-Fraud Controls implementation

- **Hotline**: 2010 - 51%, 2020 - 64%, Increase: 13%
- **Anti-Fraud Policy**: 2010 - 43%, 2020 - 56%, Increase: 13%
- **Fraud Training for Employees**: 2010 - 44%, 2020 - 55%, Increase: 11%
- **Fraud Training for Managers/Executives**: 2010 - 46%, 2020 - 55%, Increase: 9%

- Effectiveness and Weaknesses of Anti-Fraud Controls

High Level Findings: (cont.)

- **Type:** 70% of frauds occurred in for-profit organizations, with 44% of the victims being private companies and 26% public.

- **Distribution:** Cases reported were evenly distributed, with about 25% in each size category (small, large, etc.). Median loss varied between USD 100,000 and USD 150,000 (a small business feel it more).

- **Industries:** The most common industries reported were banking and financial services, government and public administration, and manufacturing. The mining industry suffered the highest median loss of USD 475,000, and energy sector had the next-highest (USD 275k).
Mots impacted industries:

- Agriculture, forestry, fishing, and hunting
  - Median Loss: $100,000
  - Cases: 40
- Arts, entertainment, and recreation
  - Median Loss: $90,000
  - Cases: 39
- Banking and financial services
  - Median Loss: $100,000
  - Cases: 386
- Communications and publishing
  - Median Loss: $115,000
  - Cases: 15
- Mining
  - Median Loss: $475,000
  - Cases: 26
- Real estate
  - Median Loss: $254,000
  - Cases: 52
- Religious, charitable, or social services
  - Median Loss: $76,000
  - Cases: 43
- Retail
  - Median Loss: $85,000
  - Cases: 91
- Construction
  - Median Loss: $200,000
  - Cases: 80
- Education
  - Median Loss: $65,000
  - Cases: 82
- Energy
  - Median Loss: $275,000
  - Cases: 91
- Food service and hospitality
  - Median Loss: $114,000
  - Cases: 60
- Services (other)
  - Median Loss: $150,000
  - Cases: 30
- Services (professional)
  - Median Loss: $150,000
  - Cases: 54
- Technology
  - Median Loss: $250,000
  - Cases: 67
- Telecommunications
  - Median Loss: $250,000
  - Cases: 67
- Government and public administration
  - Median Loss: $100,000
  - Cases: 195
- Health care
  - Median Loss: $200,000
  - Cases: 149
- Insurance
  - Median Loss: $70,000
  - Cases: 85
- Manufacturing
  - Median Loss: $198,000
  - Cases: 185
- Transportation and warehousing
  - Median Loss: $150,000
  - Cases: 65
- Utilities
  - Median Loss: $163,000
  - Cases: 20
- Wholesale trade
  - Median Loss: $130,000
  - Cases: 25

Red Flags

7 KEY WARNING SIGNS

- **42%** Living beyond means
- **26%** Financial difficulties
- **19%** Unusually close association with vendor/customer
- **15%** Control issues, unwillingness to share duties
- **13%** Irritability, suspiciousness, or defensiveness
- **13%** "Wheeler-dealer" attitude
- **12%** Divorce/family problems

Fraud in Construction
Types of Fraud per Industry

- Corruption: A scheme in which an employee misuses their influence in a business transaction in a way that violates their duty to the employer in order to gain a direct or indirect benefit (e.g., schemes involving bribery or conflicts of interest).

- Financial statement fraud: A scheme in which an employee intentionally causes a misstatement or omission of material information in the organization's financial reports (e.g., recording fictitious revenues, understating reported expenses, or artificially inflating reported assets).

Fraud in Construction

- The median loss found in construction fraud cases is approximately $227,000.
- According to the ACFE study, here are some of the most common types of fraudulent activities affecting the construction industry:
  - **Corruption** – Collusion between project managers and vendors/subcontractors including kickback schemes, bid rigging at the subcontractor level, conflicts of interest, bribery, etc.
  - **Billing** – Substitution of materials while billing for higher quality, falsification of pay applications and billing for uncompleted work, incorrect labor rates, etc.
  - **Expense reimbursement** – Falsifying invoices for expense reimbursements, inappropriate use of company credit cards and gas cards.
Fraud in Construction (cont.)

- **Expense reimbursement** – Falsifying invoices for expense reimbursements, inappropriate use of company credit cards and gas cards.

- **Noncash misappropriation** – Stealing the noncash assets of a company assets such as job site supplies, equipment, scrap metal and other materials, etc.

- **Check and payment tampering** – Office employees may have the opportunity to write checks to fictitious vendors or collect checks from customers and hide the activity through entries to the general ledger.
Recent Real-Life Cases
Notorious examples:

- Hunter Roberts Scams Schools in New York – Hunter Roberts inflated the bills by altering labor foremen’s time sheets. It was part of the way the company kept the loyalty of their top supervisors. Hunter Roberts billed clients for work that did not occur. The company ended up shelling out $7 million for the faulty timesheets.

- Inspectors Accept Bribes to Pass Unsafe Buildings – When New York Mayor de Blasio launched an aggressive affordable housing plan (+- 50,000 new apartments by 2024), contractors rushed on the job and bribed building inspectors to the tune of $450,000.

- The Mafia Takes Over Montreal’s Buildings – testimony from cooperative construction company boss Lino Zambito talked about how building companies gave around 2.5% of “won” government contracts to friendly governmental officials and to the Mafia. Overall, three mayors resigned and faced jail time for “gangsterism.”
Case 1: Contractor CEO Accused of Defrauding The State Department


- Misrepresentations about employees’ qualifications and company’s ownership (lied that it was a female-owned)

- Cultivated an insider and paid lucrative bribes in exchange for confidential bidding information.

- Scheme to undermine procurement process, hurting other legitimate businesses competing for awards and damaging public’s trust.

- CEO was arrested to be presented before U.S. Magistrate Judge (May 28th, 2021).

- CEO charged with count and conspiracy to commit wire fraud. Maximum potential prison sentence of 20 years (x2) and one count of bribery of a public official (maximum sentence of 15 years).

Case 2: False Statements About Disadvantaged Business

- United States settled civil fraud claims against TOWER MAINTENANCE CORP., a steel painting company.
- Allegations that TOWER fraudulently obtained payments on two federally funded construction projects by causing misrepresentations of compliance with DBE rules.
- Would have caused the prime contractors on the projects to misrepresent that TOWER was solely performing work when in fact the work was managed and supervised by a non-DBE (in exchange for 50% of profits).
- TOWER admits responsibility for conduct and agrees to pay $150,000. The Office previously reached settlements to resolve fraud claims against the codefendants Spectrum and Ahern that were required to pay $3.4 million.
- Projects: Industrial painting and rehabilitation of the Brooklyn Bridge Project and overcoat painting on the elevated structure at the Queens Plaza subway station.

Case 3: JV Partner Practiced Creative Accounting and Cost Booking

- Real Estate developer from Sao Paulo state decided to invest in other states where they had no experience in. The simplest and better choice was to develop local partners.

- Strategy seemed to work for about 10 years with multiple projects being launched, constructed and sold out. However, profit rates were consistently below target and the explanation was always related to unexplainable “local requirements”.

- Real Estate developer hired an external consulting firm to independently investigate the quality of the job cost reports and found all kinds of cost being incorrectly charged to projects, including: (a) resignation costs for long standing professionals; (b) first tier acquisition of materials allocated instead of later, discounted materials; and (c) senior management corporate benefits being fully charged to projects.

Prevention vs Correction
Avoidance is possible!

Fraud is explained by the Fraud Triangle: opportunity, rationalization, and pressure. Companies will have little control over the outside pressure; therefore, controls must reduce the opportunity afforded to potential fraudsters.

Construction companies can reduce likelihood of fraud, and increase the chance of catching fraud if it occurs:

- Establish and enforce strong internal controls –
  - Segregation of duties (avoids falsification of expense reimbursements, manipulation of checks/payments or misappropriation of cash receipts).
  - Levels of approvals and oversight for bidding, selection of subs and vendors, change order approval, etc. (reduces the risk of collusion).
  - Controls over the estimate and pay application process prevent and detect issues relating to falsification of completed work, inflating labor or material costs, double dipping on billings, etc.
Avoidance is possible! (cont.)

- **Regular (or unannounced) job site visits** – Unexpected job sites visits can deter unwanted behavior from employees and provide valuable information on how a job is performing (pay applications vs estimates).

- **Due diligence** – Prequalification process for subcontractors and vendors can eliminate undesirable companies. DD can help mitigate the risks around change orders and selection of vendors/subcontractors.

- **System to Receive Anonymous Tips** – Setting up an easy medium for individuals to communicate these tips will allow for a higher likelihood of uncovering ongoing fraud.
Conclusions
Fraud happens very frequently and impacts businesses.

There are proven ways to fight fraud.

It is important to know your risks well in order to be able to define appropriate controls that act on their root causes.

Failure to implement control initiatives can result in significant losses.

Implementing robust internal controls and enforcing them can reduce the risk of fraud and related losses.
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